

Office of Chief Counsel
Internal Revenue Service

memorandum

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BETombul

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to: Anthony Shamoon, Senior Program Analyst
Office of Penalties & Interest
S:C:CP:RE:P

from: CHARLES A. HALL, SENIOR COUNSEL *Charles A. Hall*
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subject: **Application of the Failure to Deposit Penalty Under I.R.C. § 6656**

This memorandum is in response to your request that we provide guidance to your office on the application of the failure to deposit penalty under section 6656. Specifically, you asked us to determine whether the crediting of an overpayment from an earlier Form 941 return period to a later return period that satisfies the deposit liability in the later Form 941 return period should eliminate the failure to deposit penalty under section 6656.

Fact Scenario

The following is the fact scenario that you presented:

A taxpayer files Form 941 with a tax balance due, and a failure to file penalty, a failure to pay penalty, a failure to deposit penalty, and interest are assessed. The tax is subsequently satisfied with an offset (TC 706) from a prior return period, and the failure to file penalty, the failure to pay penalty, and the interest automatically abate.¹ The failure to deposit penalty, however, remains on the account.

¹ Please note that the statement in the fact scenario that the failure to file penalty, the failure to pay penalty and the interest automatically abate is not necessarily true. Those penalties and interest would only abate if the credit was allowed as of the date the return for the later period was due. You did not ask us to address those issues, however, so we will not discuss those issues further in this memorandum.

PMTA: 00632

Law and Analysis

Application of Credits from Prior Return Periods

Although it might be argued that there was no deposit requirement because the Service actually had the funds to satisfy any deposit liability prior to the beginning of the second Form 941 return period, that is not the determinative factor. Instead, it is necessary to analyze when the credit from the first period is actually considered paid against the liability for the second period.

The courts have long held that an outstanding tax liability is considered paid by a credit on the date the credit is allowed. *United States v. Swift & Co.*, 282 U.S. 468 (1931). In addition, section 7422(d) provides that for purposes of civil refund actions, the credit of an overpayment of any tax in satisfaction of any tax liability shall be deemed to be a payment in respect of such tax liability at the time the credit is allowed.

Similarly, section 6407 provides that a credit is "allowed" on the date on which the Secretary first authorizes the scheduling of an overassessment in respect of any internal revenue tax. Thus, if the Service determines that there is a credit on the taxpayer's account from an earlier Form 941 return period after the date that the return for a later Form 941 return period is due, the credit from the earlier Form 941 return period will be applied to a later Form 941 return period on the date the credit was allowed.

Section 6656 – Failure to Deposit Penalty

Section 6656(a) imposes a penalty of a certain percentage of an underpayment when a person fails to timely deposit taxes, as required by the Internal Revenue Code or regulations, unless the failure is due to reasonable cause and not due to willful neglect. Section 6656(b)(2) defines "underpayment" as the excess of the amount of the tax required to be deposited over the amount, if any, thereof deposited on or before the date prescribed therefor.

Under section 6656(b)(1), the penalty imposed by section 6656(a) is: (1) 2 percent of the underpayment if the failure to deposit is not for more than 5 days; (2) 5 percent of the underpayment if the failure to deposit is for more than 5 days but not more than 15 days; or (3) 10 percent of the underpayment if the failure is for more than 15 days. In addition, the penalty is 15 percent of the underpayment if the tax is not deposited on or before the earlier of: (1) the day 10 days after the date of the first delinquency notice to the taxpayer under section 6303, or (2) the day on which notice and demand for immediate payment is given under sections 6861 or 6862 or the last sentence of section 6331(a).

Revenue Procedure 90-58, 1990-2 C.B. 642, addressed the application of deposits

within a return period and the application of credits from one return period to another. Example 4 in section 3.04 of Rev. Proc. 90-58, 1990-2 C.B. 642, provided that an overdeposit from one return period could not be credited to satisfy a deposit liability in the next succeeding return period. Revenue Procedure 90-58 also provided that all credits applied to a taxpayer's deposit liability for a specific return period were applied according to the normal rules regarding the application of deposits. Thus, a credit that was transferred to another return period's account would be applied as of the date that the credit for the earlier period was allowed, which would necessarily be after the date that the return for the earlier period was filed and the amount of the credit was determined.

Revenue Procedure 91-52, 1991-2 C.B. 781, clarified and amplified section 3.04 of Rev. Proc. 90-58 by providing that a taxpayer could elect to apply an overdeposit from one return period to the next succeeding return period. Revenue Procedure 90-58, as clarified and amplified by Rev. Proc. 91-52, provided that, solely for purposes of determining the applicability of the section 6656 penalty, when a taxpayer elects to apply an overdeposit from one return period to the next succeeding return period, the deposit will be credited as of the date the deposit was actually made, as opposed to the date that the return was filed. The exception in Rev. Proc. 91-52 for applying credits as of the date the deposit was made for purposes of determining the section 6656 penalty would not apply to the fact scenario, above, however, because the taxpayer did not elect to credit an overpayment from one return period to the deposit liability for the next succeeding return period.

Revenue Procedure 2001-58, 2001-2 C.B. 579, provides guidance for applying tax deposits for purposes of determining the failure to deposit penalty in order to conform to changes made to section 6656 by the IRS Restructuring and Reform Act of 1998 (RRA). Section 6656(e)(1) of the Code, as added by section 3304(a) of RRA and amended by section 3304(c) of RRA, addresses the application of deposits within a return period in an effort to address the problem of "cascading penalties" when one or more deposits within a return period is not made timely. The changes made by RRA section 3304(a) and (c) do not address the crediting of an overpayment from one return period to another. Revenue Procedure 2001-58 also only addresses the application of deposits within a return period in an effort to avoid the problem of cascading penalties. It does not address the crediting of an overpayment from one return period to another. Even so, Rev. Proc. 2001-58 obsoletes Rev. Proc. 90-58 and Rev. Proc. 91-52.

Application of the Failure to Deposit Penalty in the Fact Scenario, Above

Although Rev. Proc. 90-58 and Rev. Proc. 91-52 are now obsolete, the procedures for applying deposits and credits from one return period to another continue to apply because those procedures are consistent with the relevant provisions of the Internal Revenue Code and the corresponding Treasury regulations. In the fact scenario described above, the tax liability for the subsequent return period was satisfied by a

credit transferred from an earlier return period after the Form 941 for the later return period was filed. Therefore under sections 7422(d) and 6407, the credit satisfied the liability on the date the credit was allowed.

The failure to deposit penalty under section 6656 is a percentage of the underpayment of deposits, and the applicable percentage is determined based on the number of days that the deposit is late. In addition, even if the deposit is made timely, if the deposit is not made in the proper manner, the section 6656 penalty may be assessed. See Rev. Rul. 95-68, 1995-2 C.B. 272 (a taxpayer that is required to make a deposit by electronic funds transfer who makes a deposit using Form 8109, Federal Tax Deposit Coupon, will be assessed a 10% failure to deposit penalty under section 6656 unless the failure to make an electronic funds transfer was due to reasonable cause and not willful neglect).

In the fact scenario described above, the taxpayer had a deposit liability and failed to make timely deposits. Therefore, the failure to deposit penalty was properly applied. The subsequent satisfaction of the return liability after the Form 941 was due does not change the fact that a deposit liability was due from the taxpayer and that the liability was not timely deposited.

There is no basis for applying a rule similar to the rule in Rev. Proc. 91-52. Under that revenue procedure (and continuing even after Rev. Proc. 2001-58), a taxpayer would need to make an affirmative determination at the time of filing a return for an earlier period that a credit exists for that period and that the taxpayer wishes to apply that credit to a subsequent period. The taxpayer would need to make this affirmative determination at the time the taxpayer filed the return for the first period and prior to the end of the second period. Under the fact scenario at issue, the taxpayer has made no such affirmative determination to apply a credit. Thus, the credit should be considered paid on the date it was allowed, which in this case was after the due date for the later Form 941 return period. Accordingly, the Service should not abate the failure to deposit penalty in this fact scenario unless the taxpayer can establish that its failure to make timely deposits was due to reasonable cause and not willful neglect.

If you have any questions regarding the above analysis, please contact Bridget Tombul at (202) 622-7022.